The market that failed : a decade of neoliberal economic reforms in India/ C P Chandrasekhar , Jayati Ghosh; New Delhi: LeftWord, 2006. (1-41, 165-174 p.)

one

The Background to Neoliberal Reform

Both the advocates of neoliberal reform and its critics take as their reference point, an analysis of the factors leading up to the development impasse of the late 1960s and 1970s in India. This was a period when growth decelerated substantially relative to that recorded during the first fifteen years after Independence. This deceleration was neither accidental nor exogenously determined. Going behind the socialist rhetoric of the 1950s, it is clear that there were a number of features of India's post-Independence growth strategy that structurally limited the potential of the system. To start with, despite talk of land reform, of providing land to the tiller and curbing the concentration of economic power, little was done to attack or redress asset and income inequality after Independence. The worst forms of absentee landlordism were done away with, but the monopoly of land remained intact in most of rural India. And while some monopolistic practices were curbed, asset concentration in the industrial sector was never really challenged. Rather, India's monopolists were able to use state intervention as a device to consolidate and expand their monopolistic positions.

One consequence of the persistence of asset and income inequality was that there were definite limits to the expansion of the market for mass consumption goods in the country. Employment and income growth in the private sector was limited. And the large mass of the peasantry, faced with insecure conditions of tenure and often obtaining only small shares of the outputs they produced, had neither the means nor the incentive to invest. The prospect of increasing productivity and incomes in rural India (which was home to the majority of its population) in order to stimulate domestic demand was therefore restricted. The absence of any radical land redistribution meant that the domestic market, especially for manufactured goods, remained socially narrowly based. It also meant that the growth of agricultural output, though far greater than in the colonial period, remained well below potential. For the country as a whole, the benefits of such agricultural growth as did occur were largely confined to a relatively narrow stratum of landlords-turned-capitalists and sections of rich peasants who had improved their economic status. Meanwhile, industrial growth was not sufficiently employment generating to create large increases in demand from this source.

Under these circumstances, continuous growth in state spending was essential for the growth of the market since it was the key element in whatever overall dynamism the system displayed. Further, given the strength and assertiveness of the domestic industrial capitalists, the government was not in a position to discipline them to the extent that would have been required to launch an East Asian-style mercantilist strategy.[1] The stimulus for growth had to be internal, even though the autonomous expansion of the domestic market was constrained by the inequality of asset distribution.

In the event, the basic stimulus to growth during the early post-Independence years came from the state itself. It provided domestic capitalists with a large once-for-all market for manufactures by widening and intensifying trade protection and displacing imported goods from the domestic market. It sought to expand that market through its current and capital expenditures and it supported the domestic capitalist class by investing in crucial infrastructure sectors and channelizing household savings to finance private investment through the creation of a number of industrial development banks.

[1] The strategy employed in the successful East Asian economies involved combining cheap labour resources and state directed easy credit and other financial incentives to use private investment and production as the base for a thrust into the international market for manufactured mass consumption goods.

This strategy did pay dividends during the decade-and-a-half immediately following Independence. In this period rates of industrial growth were creditable by international standards, India built up a diversified industrial base, and the public sector expanded rapidly enough to provide crucial infrastructural services, industrial raw materials and capital goods to sustain industrial growth even when the foreign exchange available to import these commodities was limited (Chakravarty 1987). By the mid-1960s, however, not only was the once-for-all stimulus offered by import substitution exhausted, but the ability of the state to continue to provide the stimulus to growth was also undermined by its inability to raise adequate resources. In consequence, aggregate growth decelerated leading to the 'secular stagnation' of the late-1960s and 1970s.[2]

Thus the interventionist regime that was set up in the 1950s had serious internal contradictions which contributed to an erosion of its social stability as well as of its economic viability. This propelled it towards a situation where, *given its social base*, it could not summon the will for any alternative viable responses to the changed international economic context. Thus, the development of international capital markets and consequent access to private capital flows added tensions to a regime which had been based on certain critical assumptions relating to the binding foreign exchange constraint. This interplay between the changing external context and the accentuating domestic contradictions within the earlier regime gave rise to the totality of circumstances that permitted the overt shift in policy making in favour of neoliberal economic reforms. Thus, while the speculation-engendered crisis of 1990–91 provided the immediate occasion for the 'economic reform' package, there were fundamental internal contradictions and structural features that had led up to it.

The economic policy regime erected in the 1950s had its roots in the freedom struggle itself. The economy had been dominated by metropolitan capital and metropolitan commodities in the pre-Independence period. Freedom meant freedom from this domination; and this could not be ensured without giving the state in independent India a major role in building up infrastructure, expanding and strengthening the productive base of the economy, setting up new financial institutions, and regulating and coordinating economic activity. This was necessary even for building

[2] A cogent neoclassical critique of the model was made in Bhagwati and Desai (1970), which was in turn critiqued by Bagchi (1971).

capitalism itself, although it was proclaimed by some to be also a means of transition to socialism. State capitalism and state intervention were essential instruments for the development of a relatively autonomous Indian capitalism, displacing metropolitan capital from the pre-eminent position it had occupied in the colonial economy.

There were three mutually reinforcing and interrelated contradictions that aborted the objectives of this basic model.[3] First, the state within the old economic policy regime had to simultaneously fulfil two different roles that were incompatible in the long run. On the one hand, it had to maintain growing expenditure, in particular investment expenditure, in order to keep the domestic market expanding. At the same time, however, the state exchequer was the medium through which large-scale transfers were made to the capitalist and proto-capitalist groups, so that the state effectively became the most important instrument for primary accumulation by the domestic capitalist class in its various manifestations. Of course, there were other instruments as well, some of which were more direct (such as the eviction of tenants from agricultural land, private encroachment on common and publicly owned resources such as forests from whose use the poor were simultaneously excluded). But the state exchequer was the most significant via media, through mechanisms such as tolerance of fairly widespread and growing tax evasion, a variety of subsidies and transfers, and through lucrative contracts and procurement policies.

This contradiction between these two different roles of the state was manifested in the government's revenue account. This was in surplus until the end of the 1970s, but thereafter turned to growing deficit, despite increasing resort to indirect taxation and hikes in administered prices. One result of this was that the fiscal deficit also went up, but this reflected a decline in public savings rather than an increase in productive investment.

The implications of this growing fiscal crisis were obvious: the government could either cut back on its own investment or maintain it through increased borrowing. The period from the mid-1960s to the late 1970s witnessed the first option being chosen, while from the early 1980s the second option was dominant. But such government borrowing, and the subsequent increase in public debt, in turn generated pressure for changes in economic strategy. It is easy to see why this happened. External debt held by the government obviously is limited by the growing difficulty

[3] This discussion follows upon Patnaik and Chandrasekhar (1995).

in accessing commercial loans as the size of the aggregate debt increases. And more loans become conditional on changes in economic policy towards more external liberalization. But even domestic borrowing can generate such pressures through the mechanism of inflation, if the expenditure thus financed generates output expansion which then meets with a bottleneck. The Indian economy in general has low tolerance for inflation by international standards, not only because the vast majority of workers (including cultivators) do not have inflation-indexed incomes, but because of the greater political voice of middle classes who also oppose inflation. Thus, inflation breeds social unrest that can prove explosive given India's democratic framework. However, attempts to deal with this by reducing public expenditure then meant slowing down the rate of growth of the economy, and this then energized the demands from capitalists and middle classes for an alternative policy regime. Thus, the effort to combine political legitimacy with economic dynamism forced the state into a dilemma.

The second contradiction lay in the inability of the state to impose a minimum measure of discipline among the capitalists, without which no capitalist system anywhere can generate sustained growth. Disregard for the laws of the land, including especially those relating to taxes and other laws which affected the economic functioning of the system, was an important component of capitalist primary accumulation in the post-Independence Indian case. This absence of a collective discipline in turn meant that a successful transition could not be made from the Nehruvian style of interventionist regime to an alternative viable capitalist regime with a different kind of state intervention, such as in Japan and South Korea. In East Asia, state intervention was based on close collaboration between the state and capital, and the simultaneous enforcement of fairly rigorous discipline among the capitalists. However, in India the domestic capitalist class as a whole proved incapable of submitting to or imposing upon itself a similar degree of discipline, and thus such an alternative state-supported capitalist regime could not emerge. This meant that the only feasible alternative to the earlier dirigisme instead became a process of deregulation and liberalisation.

The third contradiction had its roots in the social and cultural ambience of a developing country like India. Metropolitan capitalism has been characterized by continuous product innovation, with newer goods constantly entering the market and even creating new lifestyles. But in India, as we have seen, the market for industrial goods was limited from the early stages, with additional purchasing power dominantly accruing to a comparatively narrow social segment which in turn provided the main source of growth in demand for manufactured consumer goods. This social segment, as in most other such developing countries, was eager to emulate the lifestyles and consumption patterns of the metropolitan centre. Therefore it was not satisfied with having more domestically produced goods; rather, its demand was increasingly for the new goods produced in the metropolitan centres, which could not be locally produced using only indigenous resources and technology.

This created an imbalance between the possibilities of domestic production and the patterns of domestic demand, since much of the additional demand for consumer goods came from richer social groups. While this was sought to be contained to some extent by import controls, such controls inevitably gave rise to clandestine imports, through smuggling. In any case, this basic imbalance increased over time because of further innovations in the metropolitan economies. This created powerful and growing pressure among the more affluent groups in society for a dismantling of controls on both domestic production and imports, regardless of the effects on balance of payments and erosion of the viability of the domestic manufacturing sector. The international demonstration effect has been a powerful instrument in the hands of metropolitan capital in its efforts to prise open the markets of developing countries, and India is no exception.

The net result of the working out of all these contradictions has been evident in the Indian economy for quite some time. Changes in the rate of growth of manufacturing production over the decades provide a barometer of the possibilities of productive accumulation. In the period 1951 to 1965, manufacturing output grew at an average annual rate of 7.8 per cent, but the rest of the decade of the sixties (1965–70) saw this rate fall to only 3.3 per cent, with only a slight increase to 4 per cent over the 1970s. By the first half of the 1980s, manufacturing growth was slightly higher at an annual rate of 5.7 per cent, and for the second half of the decade it had increased to 8.8 per cent per annum on average.[4] Thus, after 15 years of

[4] These annual compound growth rates have been calculated from data in various issues of *Economic Survey*, GOI and *Report on Currency and Finance*, RBI.

rapid industrial expansion in the 1950s and the early 1960s, there was a dramatic decline in the rate of manufacturing growth during the next 15 years. Even though the growth -rate picked up somewhat in the early 1980s, it was still nowhere near the rates witnessed in the first 15 years of planning. It is only after the mid-1980s that a pronounced boom occurred once again in Indian manufacturing.

The fact that the 15 years after the mid-1960s which were characterized by a relative stagnation in manufacturing output also witnessed a decline in the rate of growth of public investment is well-known. This decline meant, as discussed earlier, that in promoting primary accumulation of capital, the state could not adequately fulfil its other role of expanding the domestic market (Bharadwaj 1994; Chandra 1988). This adversely affected a number of industries which catered to mass consumption or those with strong linkages to public investment. In addition, the sluggish rate of public investment added to infrastructure constraints upon private economic activity.[5]

Given the sluggish growth of the home market, breaking into export markets could have provided a new stimulus to industrial expansion and a new basis for capital accumulation in productive channels. But export markets were mainly dominated by metropolitan capital. Those third world industrializers that were able to enter such international markets in a significant way (such as certain East Asian economies) essentially did so on the basis of special relationships with metropolitan capital for strategic geopolitical or other reasons. Such relationships allowed them access to external capital, relatively open markets and new technologies, to varying degrees. For Indian capital to break into export markets on its own, it was necessary to have not only very substantial backing of the state but also a massive effort on the part of Indian capital itself. Because it was incapable of making such an effort, partly because of its unwillingness to accept a certain minimum discipline, the export prospects of Indian capital remained limited.

These were the factors that underlay the development impasse of the late-1960s and the 1970s. Any effort on the part of the state to accelerate growth through deficit-financed expenditures either resulted in inflation or in a balance of payments problem, or in a combination of the two. The

[5] A number of papers on industrial stagnation in India after the mid-sixties are collected in Nayyar (1994).

state was constrained to avoid both of these outcomes beyond a certain limit. Since this feature of Indian political economy did not change subsequently, the revival of growth in the 1980s appears puzzling at first glance. This issue is considered in the next chapter.

two

The Recovery of the 1980s

As we have seen, the decade of the 1980s witnessed a recovery and even acceleration of both GDP growth and manufacturing activity. This return to economic buoyancy cannot be attributed to the emergence of any *new* source of stimulus to growth. Exports during these years were by no means remarkable enough to stimulate growth in an economy as large as that of India. And the factors which had earlier constrained the expansion of the mass market were still operating. This implied that the stimulus to growth, as before, had to come from the state (Chakravarty 1987; Patnaik 1995).

And this is essentially what happened. Three new features characterized the 1980s, which allowed the economy to escape from the growth impasse of the earlier period. First, there was a big increase in the fiscal stimulus to the economy provided by government spending. Second, there was substantial liberalization of imports, especially of capital goods and components for manufacturing. Third, associated with both of these, there was a shift to relying on external commercial borrowing by the state to finance the increases in the consequent fiscal and current account deficits.

In terms of fiscal stimulus, there was a significant increase in the total fiscal deficit as a share of national income. The gross fiscal deficit of the central and state governments together averaged 9.5 per cent of GDP at current market prices in the second half of the 1980s and touched 10.1 per cent in 1990–91. This was not due to any increase in the share of public investment, but largely the result of a decline in the share of public savings, reflected in the burgeoning revenue deficit (which rose from an average of 2.8 per cent of GDP during 1985–86 to 1989–90 to 4.5 per cent in 1990–91). Current expenditures of the state grew at a rate which outstripped by far the growth in tax and non-tax revenues, despite hikes in indirect taxation and in administered prices.

There were several factors behind this. There was the government's refusal to garner larger direct tax revenues for reasons which have already been discussed. There was the growing expenditure on interest payments because of past deficits, and on certain subsidies, especially on fertilizers (caused primarily by wrong technological choices involving the setting-up of plants with very high capital costs).[1] And there was also the general increase in all sorts of government spending. Since relatively more of such expenditure was directed towards rural areas than was earlier the case, this meant increased multiplier effects on economic activity in both urban and rural areas.

The second new feature was the liberalization of imports of capital goods and components required for a number of commodities catering to luxury consumption, especially of electronics and automobiles. This was based on the argument – explicitly stated by some government officials – that since even the small segment of the population that demanded such goods amounted in absolute terms to a fairly large number, the economy could grow on the basis of such an industrialization strategy whose benefits would eventually 'trickle down' to the poorer sections of the population as well.

The import liberalization of the late 1980s was not tied to a larger export effort; its main immediate thrust was towards producing more goods – luxury goods – for the domestic market. In 1985–86, the very first year that the policy was introduced, there was a dramatic increase in balance of payments deficits, with the current account deficit increasing to 2.26 per cent of GDP. While it reached a plateau thereafter, this still reflected a very large increase in non-oil imports, since there was a significant reduction in India's oil import bill between 1984–85 and 1988–89 owing to the development of

[1] See Dhar (1984) for a discussion of this.

the Bombay High oilfield. But for the import profligacy, the trade deficit would have declined significantly in absolute terms since mineral oil and related products accounted for nearly a third of India's import bill at the start of the 1980s.

Meanwhile, remittance inflows during this period had flattened out and 'soft loans' were becoming more and more difficult to come by. In this context, the maintenance of a high, even though steady, absolute level of the trade deficit, and the related need to finance large current account deficits, turned out to be an extravagance that could not be sustained. It should be noted that more than 40 per cent of the increase in import value between 1984–85 and 1988–89 (barring what was effectively re-exported) was on account of machinery and transport equipment, including components, which went to a significant extent into the production of a variety of goods for upper income groups (Chandra 1986, 1991).

The third new feature was a systematic resort to commercial borrowing from abroad, including from the NRIs. As the trade and current account deficits went up in the latter half of the 1980s, and access to soft loans dwindled, there was increasing recourse to external commercial borrowings. This in turn contributed, with a lag, to large current account deficits because of the need for debt servicing, and eventually necessitated further borrowing. Debt has a habit of escalating rapidly, feeding upon itself. As fresh debt was contracted even to pay off old debt, the terms at the margin became stiffer, the maturity period shorter, and hence the rate of escalation of debt increased as well. The debt in dollar terms nearly quadrupled during the 1980s, from around $20 billion in 1980 to nearly $82 billion in 1990; debt to banks and private individuals increased more than 10 times from just under $2 billion to more than $22 billion. By 1990, India's debt-service payments absorbed foreign exchange amounting to nearly one-third of the value of exports.[2]

It is the combination of these three features which explains the state's ability to pull the economy out of the impasse it faced during the late 1960s and the 1970s. Of course it can be asked why the earlier successive governments – which were after all just as desperate to revive growth – could not adopt a similar strategy. To answer this we need to look at developments outside the

[2] While this increase in external debt was not quite as rapid and extensive as had occurred in the previous decade in some Latin American economies, it was nevertheless very significant in terms of India's balance of payments.

country, which influenced India's medium-term growth prospects significantly. The rise to dominance of finance capital in the international economy was the most important of such developments.

Until the early 1970s, the private international financial system played only a limited role in recycling financial surpluses to the developing countries. Capital flows to developing countries, barring a few unusual exceptions like South Korea, were through official bilateral and multilateral channels. The period immediately after the first oil shock saw a dramatic change in this scenario. Since oil surpluses were held mostly as deposits with the international banking system based in and controlled by the developed world, the private financial system there became a powerful agent for recycling surpluses. This power was immense. The expenditure that was fuelled by such credit in both the developed and developing worlds, generated further surpluses with the oil producers, who then deposited these surpluses with the transnational banks, who, in turn, could offer further doses of credit. By 1981, OPEC countries are estimated to have accumulated surpluses to the tune of $475 billion, $400 billion of which was parked in the developed industrial nations.

This power of finance was all the more significant because a slow down in productivity growth in metropolitan industry was already bringing the post-War industrial boom to a close, and this process was being hastened by the contractionary response to the oil shocks. As a proportion of world output, net international bank loans rose from 0.7 per cent in 1964 to 8.0 per cent in 1980 and 16.3 per cent in 1991. Relative to world trade, net international bank loans rose from 7.5 per cent in 1964 to 42.6 per cent in 1980 and 104.6 per cent in 1991 (World Bank, World Debt Tables, various issues).

Two other developments contributed to the increase in international liquidity during the 1970s and 80s. First, the United States had built up large international liabilities during the Bretton Woods years, including those resulting from expenditures on the Vietnam War and its policing efforts elsewhere in the world. The explosion of the Eurocurrency market in the 1970s reflected this.[3] This was sustained by the confidence in the dollar stemming from the immediate post-War hegemony of the US, which

[3] 'Eurocurrency' markets involve transactions related to accounts which are kept in currencies that are not those of the nation in which the bank is located, such as US dollar accounts held in banks in, say, Britain.

made it as good as gold. Such international confidence in its currency allowed the US to ignore national budget constraints on its international spending and resulted in the emergence of strong banking and financial interests with an international agenda. The influence of these interests was reflected in policies that affected domestic manufacturing interests adversely, as suggested by the widening and persistent US trade deficit after the mid-1970s.

Second, the loss of manufacturing competitiveness in the US meant that during different periods since the 1970s the dollar temporarily lost its position as the only acceptable reserve currency, fuelling speculative demand for other currencies. Such speculative demand, needless to say, is sensitive to both interest rate differentials and exchange rate variations, resulting in volatile flows of capital across currencies and borders. The results of these developments were obvious. Thus, the daily volume of foreign exchange transactions in international financial markets rose to $1.2 trillion per day by the mid-1990s, which was equal to the value of world trade in every quarter of a full year. In the early 1980s the volume of transactions of bonds and securities between domestic and foreign residents accounted for about 10 per cent of GDP in the US, Germany and Japan. By 1993 the figure had risen to 135 per cent for the US, 170 per cent for Germany and 80 per cent for Japan. Many of these transactions were of bonds of relatively short maturities (Zevin, 1993; Bello, Bullard and Malhotra 2000).

There were also other real factors that created pressures for the expansion of finance. These included the changing demographic structure in most of the advanced countries, with baby boomers reaching the age when they would emphasize personal savings for retirement. This was accentuated by changes in the institutional structures relating to pensions, whereby in most industrial countries, public and private employers tended to fund less of the planned income after retirement, requiring more savings input from employees themselves. All this meant growing demand for more variety in savings instruments as well as higher returns, leading to the greater significance of pensions funds, mutual funds and the like.

Financial liberalization in the developed countries, which was closely related to these developments, further increased the funds available in the system. First, it increased the flexibility of banking and financial institutions when creating credit and making investments, as well as permitted the proliferation of institutions like the hedge funds[4] that, unlike the banks, were not subject to regulation. It also provided the space for 'securitization', or capital flows in the form of stocks and bonds rather than loans, and 'financial innovation', or the creation of a range of new financial instruments or derivatives such as swaps,[5] options[6] and futures[7] that were virtually autonomously created by the financial system. These instruments allowed players to trade 'all the risk of an underlying asset without trading the asset itself'. Finally, it increased competition and whetted the appetite of banks to earn higher returns, thus causing them to search out new recipients of loans and investments in economic regions that were hitherto considered risky.

The massive increase in international liquidity that followed found banks and non-bank financial institutions desperately searching for the means to keep their capital moving. At first, there were booms in consumer credit and housing finance in the developed industrial nations. But when

[4] A 'hedge' is a commodity, currency, or financial transaction which tends to generate the opposite effect of some other transaction, and is engaged in to minimize any possible loss from the latter. Thus a possible loss because of a fall in the value of a currency being held by an agent can be covered by a forward purchase of the same currency at a fixed price. Futures and options contracts are used to hedge commodity and securities transactions. 'Although there is no simple definition of a hedge fund, they do have certain things in common. They are structured as limited partnerships, often offshore, which means that they are largely unregulated. They charge fat fees, normally 20 per cent of profits. They are open only to the rich, to whom they offer the prospect of making absolute returns rather than relative ones – that is, they concentrate on making money, not on outperforming an index. Do hedge funds speculate wildly? Many see themselves not as speculators at all but as arbitrageurs. That means they are looking for assets whose prices are temporarily out of line with their fundamental values, selling those they deem expensive or buying any they think cheap. By doing this, in principle, the hedge funds can help to make markets more efficient. Given the huge losses run up by some hedge funds, "arbitrage" might now look like a fancy word for reckless speculation.' From 'The Risk Business', *The Economist*, London, 17 October 1998.

[5] A 'swap' is a transaction whereby a security is sold to a buyer in exchange for the purchase of another of the same value. The idea is to achieve a perceived improvement in the quality of the portfolio held by both parties.

[6] An 'option' contract gives the beneficiary the right to buy or sell a financial asset or commodity at a specified price within a specified period. The beneficiary can choose either to exercise the option or disregard it. It amounts to a bet on rates of change in the price of the asset or commodity.

[7] A futures contract allows the holder to purchase or sell a fixed amount of commodities or financial assets at a pre-specified price at a particular future date. It amounts to a bet being placed on the future value of the commodity or asset.

those opportunities petered out, a number of developing countries were discovered as the 'emerging markets' of the global financial order. Capital in the form of debt and equity investments began to flow into these countries, especially those that were quick to liberalize rules relating to cross-border capital flows and regulations governing the conversion of domestic into foreign currency.

From the point of view of governments in certain developing countries, this growth in international finance appeared positive. Some of them needed the liquidity to finance their post-shock deficits. But for others, which were not willing to undertake the structural reforms that would involve attacking the very landed and industrial interests they represented, and were therefore stuck without an alternative in the face of the development impase after the 1960s, the new situation appeared to offer a lifeline. They could now experiment with the alternative of opening up their economies, integrating with world capitalism and hope to derive at least some of the benefits of whatever growth occurred in the world system. This was certainly true of India in this period.

This option did not exist earlier, since the very process of opening up would have involved a rise in the current account deficit to levels not warranted by their access to finance through the development aid network. The resulting balance of payments problem would have necessitated an immediate reduction in growth, ensured through a state-led deflation. Larger access to international finance seemed to allow for the possibility of running larger current account deficits, permitting the state to liberalize the economy and hoping that in the medium term this would trigger an increase in exports. This seemed all the more attractive because governments found it easier to negotiate with a relatively atomistic international banking system that could impose no conditions rather than the centralized multilateral financial institutions like the IMF. Banks flush with funds were keen to lend, and the possibility that the rather high current account deficits they were financing were unsustainable was not considered. No level of the current account deficit was unacceptably high. What mattered was that the changing nature of the international financial system, which had hitherto had kept the volume of commercial borrowing by these countries relatively low. Liberalization, which was not a relevant option under the earlier international financial framework, was all of a sudden a real and even attractive option.

Thus, this congruence of interests – of the developing countries to borrow and the banks to lend – resulted in the fact that the current account deficit was for almost a decade-and-a-half no constraint on growth in at least some underdeveloped countries. The fall-out of this scenario is now history. Right through the 1970s and 80s – and of course definitely by the 90s – governments in one developing country after another combined more liberal growth strategies with huge budget deficits financed with international borrowing. This also served to neutralize at least partly, the adverse effects of trade liberalisation on domestic growth. In fact, during those years many developing countries actually recorded rather creditable rates of growth. Typically, these were then attributed to liberalization rather than to reckless excessive use of deficit financed spending by domestic governments, which the irresponsible lending practices of the international banking system had in turn encouraged. [8]

Seen in this light, the revival of growth in India during the 1980s is far easier to explain. Exploiting the access to foreign exchange that was afforded by the rise to dominance of finance internationally, the government chose to depend upon borrowing to finance a fiscal stimulus.. Rising government expenditure, however, was not accompanied by an increase in resource mobilization through rising taxes. The fiscal stimulus was financed through rising deficits, including a rising deficit on the revenue account of the government's budget. The demand stimulus resulting from such expenditure was serviced by domestic industry with the help of imported capital goods, intermediates and raw materials, imports of which were liberalized. This essentially meant that the import intensity of domestic production rose. But such growth was not constrained by inadequate access to foreign exchange, since it was accompanied by an increase in foreign borrowing from the IMF, the international commercial banking system and non-resident Indians. Fortunately for India, this was the time when remittances from Indian workers, especially in the Gulf, to sustain the consumption expenditures of families left behind in the country, provided the country with a fortuitous inflow of foreign exchange. Despite this, India's foreign debt to GDP ratio doubled during the 1980s. It was when international creditors chose to shut off such credit at the end of the 1980s that India ran into the balance of payments crisis of 1990–91, which provided the grounds for advocates of reform to push through an IMF-style stabilization and adjustment strategy.

[8] These issues are discussed in more detail in Ghosh and Chandrasekhar (2001).

If the large fiscal deficits of the 1980s had not been accompanied by large current account deficits on the balance of payments, the inflationary pressure would have grown faster and there would have been much higher inflation in the 1980s than actually occurred. On the other hand, if the current account deficit had been as large as it was owing to import liberalization but the fiscal deficits had actually been smaller, then imported goods would have undercut domestic goods and penetrated the domestic market to a greater extent (since the home market would have been narrower with a smaller fiscal deficit), and there would have been a larger extent of deindustrialization and hence a smaller rate of industrial growth.

However, while the industrial boom of this period seemed to paper over the basic contradictions of the regime, it left the economy on a powder-keg. The enormous external debt, a growing portion in the form of short-term borrowing, made the economy acutely vulnerable to currency speculation and 'confidence crises' of international investors. This type of vulnerability was an entirely new phenomenon for the Indian economy. The liquidity build-up in the domestic economy which inevitably followed made it acutely vulnerable to sudden inflationary upsurges. This was dramatically illustrated in 1990–91, which experienced an inflationary episode on account largely of speculative stock-holding, and a balance of payments crisis largely on account of NRIs taking funds out. Thus, the 1990–91 crisis was not one that afflicted the real economy; rather, it was predominantly a financial crisis.

There were many lessons to be learnt from the 1980s experience. First, despite liberalization, however 'limited', given the Indian economy's dimensions and its specific characteristics, growth depended on the fiscal stimulus that government expenditure provided, rather than on an expansion of exports. Second, if such government expenditure was not accompanied by tax and other measures aimed at mobilizing additional resources, but was financed through borrowing, the excess demand in the system was bound to spill over in the form of either inflation or a current account deficit. Third, if inflation was kept under control through imports, more external borrowing to finance the resultant deficit on the current account would be inevitable. Fourth, if this process was accompanied by trade liberalization, the size of the current account deficit and the consequent level of external borrowing would be even higher, especially since there existed a large pent-up demand for foreign goods or import-intensive domestically produced goods among the upper and upper-middle classes.

Rather than understand this complex history, the IMF and the international financial interests it represents, as well as the domestic advocates of reform who had internalized the IMF viewpoint, chose to emphasize a partial reading of the problem. They argued that the 1990s crisis derived from three sources. First, an excessive presence of government both as a regulator and a participant in economic activity, which stifled private initiative. Second, excessive government spending and a fiscal deficit that was too high. Third, inadequate liberalizing reform that supposedly prevented India's exports from rising fast enough.

Because it framed the problem in this manner, the neoliberal reform programme could focus on a chosen set of areas. It made curtailment of the fiscal deficit the fundamental task of fiscal policy. It accelerated trade liberalization, which involved doing away with quantitative restrictions on imports and reducing customs tariffs, with attendant revenue implications. It dismantled controls on the free operation of large industrial capital, domestic and foreign. It provided a host of direct and indirect tax concessions to industry, reducing the tax base of the government further. It provided a host of concessions to foreign investors, in the hope that they would use India as a base for world market production. It placed an emphasis upon financial liberalization, both internal and external. The contours of this programme are delineated in the next chapter.

three

The Contours of Neoliberal Reform

The accelerated programme of neoliberal reform that was adopted in 1991 had two separate but interlinked aspects, of stabilization followed by structural adjustment. The initial stabilization component aimed at deflating the economy, reducing the rate of growth and curbing the 'excessive' demands that were being placed on India's limited pool of foreign exchange, in order to reduce the balance of payments deficit. Devaluation of the rupee, along with an initial period of import compression ensured with import curbs, was soon substituted with a deflationary stance that was expected to reduce domestic demand and absorption to levels where the import bill was sustainable. However, stabilization was seen as a temporary strategy, inasmuch as the very act of stabilizing the economy was expected to restore international investor confidence, increase access to foreign exchange, and permit a higher rate of growth.

Conceptually, it was at this point that the second aspect of the programme, structural adjustment, was expected to take over. It was argued that renewed access to foreign exchange should not be used, as it had been earlier, to sustain higher expenditures by the state. Rather, since government deficits were seen as responsible for the crisis in 1991, the state should strive to reduce its deficits, essentially through expenditure curbs. Growth would be based largely on private initiative, as the release of private 'animal spirits' would allow the economy's comparative advantage to be exploited. This in turn would mean the creation of internationally competitive capacities so that export production would provide the principal external stimulus to economic expansion. It was believed that in this environment, any temporary excess demand for foreign exchange would be redressed by the autonomous adjustment of a market determined exchange rate.

With the core objective of the programme phrased in this manner, the policies to be followed seemed obvious to neoliberal reformers. The state's economic presence should be substantially reduced with the aim of curbing deficits. This would entail not only opening up new fields to the private sector, but also doing away with the bureaucratization, over-manning, and soft budget constraints typical of state enterprise. Imports should be liberalized not only to provide the domestic private sector with access to the capital goods, intermediates, and raw materials needed to restructure and become internationally competitive, but also to expose it to the cutting edge of international competition. Domestic deregulation was seen as providing the flexibility required for restructuring and to allow market forces to play their role in disciplining economic activity. Greater freedom to international capital, both productive and financial, must be provided to increase access to foreign finance as well as to exploit the benefits of the improved technology, modern management practices and links to international markets that transnational firms offer. To ensure that private initiative would more than adequately replace the state as the locomotive of growth, tax policies would have to be rationalized and the tax regime rendered less 'burdensome', so that the taxation regime would not act as a disincentive to save and invest. These parameters determined the large number of policy shifts that, over the 1990s, helped put in place a qualitatively new policy regime in India, and gave the liberalization of that decade its distinctive character.

REDEFINING THE ROLE OF THE STATE

Reduction of the fiscal deficit was central to both the stabilization and structural adjustment components of the neoliberal reform package. This led to the formulation that the fiscal deficit of the government should be

reduced from its record high of 8.3 per cent of GDP in 1990–91 to a targeted 3–4 per cent of GDP over a relatively short span of time. There were two factors that made this difficult. First, because the large increases in public debt that occurred in the 1980s were contracted on increasingly onerous terms, interest payments amounted to as much as one-third of the central government's revenue expenditures in 1991–92. These had to be met, and could be reduced only as fast as the growth in the volume of debt itself was curtailed. Meanwhile proposed financial liberalization, which forced the government into more costly forms of market borrowing, meant that the cost of servicing any debt contracted would be higher. Second, since the tax regime was to be rationalized to do away with disincentives to save and invest for the private sector, deficit reduction could not be based on additional resource mobilization, but would mainly involve cuts in expenditure.

It is important to bear in mind that these were not inevitable strategies; rather, they were options that were chosen because of essentially political choices about which groups in society would have to bear the burden of adjustment. Thus, the neoliberal reform programme effectively chose the interests of large capital over those of ordinary citizens whose access to productive employment opportunities as well as to public goods and services would deteriorate.

Given these self-imposed constraints, the government identified a number of means of dealing with the fiscal deficit. The first was to reduce expenditures other than those on interest payments, especially the expenditures of the government on subsidies and administration, both of which were considered excessive and reflective of inefficiency. The major item of expenditure that was expected to be pruned was the outlay on subsidies, but other expenditures, such as capital expenditure, were the ones that were in actual fact cut back even more drastically.

STRUCTURAL ADJUSTMENT AND LIBERALIZATION AT THE SECTORAL LEVEL

The principal aims of the structural adjustment policies adopted as a part of the reform process were: (*i*) to do away with or substantially reduce controls on capacity creation, production and prices, and let market forces influence the investment and operational decisions of domestic and foreign economic agents within the domestic tariff area; (*ii*) to allow international competition and therefore international relative prices to influence the decisions of these agents; (*iii*) to reduce the presence of state agencies in production and trade, except in areas where market failure necessitates state entry; and (*iv*) to liberalize the financial sector by reducing controls on the banking system, allowing for the proliferation of financial institutions and instruments and permitting foreign entry into the financial sector. As we have seen, these were based on the notion that greater freedom given to private agents and market functioning would ensure more efficient and more dynamic outcomes. Obviously, these aims had particular policy implications in the different sectors, which we consider below.

INDUSTRIAL POLICY

Post-reform industrial policy moved in three principal directions. The first was the removal of capacity controls by 'dereserving' and 'delicencing' industries, or abolishing the requirement to obtain a licence to create new capacity or substantially expand existing capacity. As a result of the dereservation of areas earlier reserved for the public sector and the successive delicencing of industries, there were only nine industries for which entry by private investors was regulated at the end of 1997–98. This meant that domestic private investors were free to invest in capacity and production in a wide range of industries which were previously regulated, including heavy industries, automobiles, and other sectors.

The second area of industrial reform related to the dilution of provisions of the Monopolies and Restrictive Trade Practices (MRTP) Act, so as to facilitate the expansion and diversification of large firms or firms belonging to the big business groups. Prior to 1991, all firms and interconnected undertakings with assets above a certain size (which was pegged at Rs. 100 crore in 1985) had been classified as MRTP units which required special approvals to undertake new investments. The MRTP Amendment Bill removed the threshold limits with regard to assets for defining MRTP or dominant undertakings, thereby removing any special controls on large firms.

The third type of liberalization in industry involved foreign investment regulation. The first step in this direction was the grant of automatic approval, or exemption from case by case approval, for equity investment of up to 51 per cent and for foreign technology agreements in identified high-priority

industries.[1] Subsequently, the Foreign Exchange Regulation Act was modified so that companies with foreign equity exceeding 40 per of the total were to be treated on par with India companies. Further, Non-Resident Indians and overseas corporate bodies owned by them were permitted to invest up to 100 per cent equity in high-priority industries, with greater freedom for repatriation of capital. Foreign investors were allowed to use their trademarks in Indian markets. The government – through the newly created Foreign Investment Promotion Board – was liberal in approving proposals and providing a high equity share to foreign investors going up to 100 per cent in many cases. Subsequently, automatic approval was allowed for foreign equity in excess of 51 per cent in certain sectors, for example up to 100 per cent in the pharmaceutical industry. There was also a range of fiscal concessions and incentives for mergers and acquisitions including those involving foreign firms.

The net result of all these manoeuvres was that interventionist barriers to entry of domestic and foreign investors into a number of industries were substantially diluted or done away with, resulting in what has been proclaimed as a much more competitive environment in the industrial sector. It was hoped that this more competitive environment would in itself induce higher rates and greater efficiency of investment and would thereby lead to accelerated industrial growth. An implicit assumption was that the beneficial effects of this would far outweigh any negative impetus of reduced public investment. The actual effects of this strategy are discussed in Chapter 5. However, it must be noted here that after an initial spurt led by an import-led consumer boom, growth rates in the industrial sector slumped once again and manufacturing industry has been in recession since mid-1996. This suggests that liberalization *per se* has not been enough to ensure high rates of growth of investment and productive activity, and that other strategies may be necessary to encourage the 'animal spirits' of entrepreneurs.

TRADE LIBERALIZATION

The major policy shift contributing to heightened competition in the domestic market was the liberalization of the import trade. A distinguishing

[1] The condition for this freedom in technology agreements in high-priority areas was that royalty should not exceed 5 per cent of domestic sales (8 per cent of export sales) and lump-sum technical fees should not exceed Rs. 1 crore.

feature of the economic reforms of the 1990s was the effort to dilute import controls by rapidly reducing the number of tariff items subject to quantitative restrictions, licensing, and other forms of discretionary controls on imports. In fact, most of these have since been abolished excepting in a very few industries. Along with this, there were continuous cuts in the tariff rates on a wide range of commodities. The peak tariff rate fell from more than 300 per cent at the start of the 1990s to less than 40 per cent by 2001.

For the first half of the decade, the process of tariff reduction was not uniform across industrial sectors. Imports of capital goods and intermediates were the first to be substantially liberalized by placing them under the OGL category,[2] by reducing tariffs and by offering concessional duties for 'project imports' and imports allowed at zero duty subject to promises of exports to be realized. In the case of consumer goods, for most of the decade the government was more cautious, with regard to the shift away from quota controls and duty reduction. This was justified by revenue considerations and the 'non-essentiality' of such goods given extant domestic production. However, over the three annual Export-Import Policies presented by the BJP-led government from 1998–99 onwards, there was complete liberalization of the import of consumer goods. By 2001, barring a very few items, the only form of protection afforded to the domestic productive sectors was that offered by tariffs, which were also simultaneously being reduced.

Obviously, given the largely 'closed' structure of the Indian economy over the broad post-Independence period, this was bound to have very significant effects on patterns of production and viability of different types of economic enterprise. The government's aim was to restructure production towards areas of international 'comparative advantage' (defined in static rather than dynamic terms). These areas were also seen as inherently more labour-intensive, which led to the further prediction that, after an initial brief period of net job loss, such a strategy of trade liberalization would actually create more employment over time in more sustainable ways. There are, of course, problems with such an argument. The first is the implicit assumption that international markets in most traded goods are actually free and competitive, and do not reflect the very extensive implicit and explicit

[2] The 'OGL' or 'Open General License' category includes commodities which do not require an import license but can be freely imported on payment of the specified tariffs.

subsidies provided by states across the world on various forms of production or the market imperfections created by concentration and centralization. This is obviously not the case,[3] and therefore the resulting patterns of trade may well be quite different from those anticipated on the basis of such an assumption. The second false premise is that capital and labour can move (with relatively little cost) from one activity to another and enable structural transformation through trade. But the most significant assumption of all is rarely mentioned in the literature. The basic neoclassical theory of gains from trade utilizing comparative advantage assumes full employment, and it is very clear from recent theoretical work that the normative results of such theory are dramatically altered once it is recognized that the economy need not settle at full employment.[4] There are other crucial assumptions relating to the nature of technology and economic organization. Recognizing the existence of economies of scale and learning effects allows for the possibility of dynamic comparative advantage which may require quite different policy responses. Thus, free trade does not necessarily emerge as the best policy choice for an industrializing economy, and trade liberalization may well lead to aggregate production effects which are negative. If these affect incomes such that consumption levels are also affected, then the case for unilateral trade liberalization becomes theoretically much more problematic.

Since the basic assumptions underlying the trade reform were not valid in the Indian context in this period, it is not surprising that the actual effects of such liberalization have been quite different from those anticipated. These effects are described in more detail in Chapters 5, 6 and 10. Here it may be briefly stated that the brief spurt in industrial activity in the mid-1990s followed by the subsequent recession in manufacturing can be related at least partly to the effects of import liberalization. Meanwhile, the trade strategy has not entailed a major positive shift in the structure and growth of production or exports. Instead, most Indian producers have experienced

[3] The very extensive state support to agriculture in many developed countries is well known, but there are many forms of implicit subsidy of other forms of production which are not so widely recognized. Thus, lower interest rates on average, cheaper and better quality infrastructure provision, and so on, contribute to lower costs for individual exporters in any country, and obviously affect international competitive conditions for producers in other countries who do not have access to similar conditions.

[4] See, for example, Krugman (1994).

an erosion of competitive position (in both export and import markets) even as their costs have continued to rise in important areas such as infrastructure and finance.

REFORMS IN AGRICULTURE

The economic reforms did not include any specific package specifically designed for agriculture. Rather, the presumption was that freeing agricultural markets and liberalizing external trade in agricultural commodities would provide price incentives leading to enhanced investment and output in that sector, while broader trade liberalization would shift intersectoral terms of trade in favour of agriculture. However, there were other changes in patterns of government spending and financial measures which also necessarily affected the conditions of cultivation, often in ways very different from those that were anticipated by the architects of the reform process.

The post-reform strategy involved the following measures which specifically affected the rural areas:

- Actual declines in central government revenue expenditure on rural development, cuts in particular subsidies such as on fertilizer in real terms, and an overall decline in per capita government expenditure on rural areas.
- Very substantial declines in public infrastructure and energy investments that affect the rural areas. These were especially marked in irrigation and transport, both of which matter directly and indirectly for agricultural growth and productivity through their linkage effects.
- Reduced spread and rising prices of the public distribution system for food. This had a very important effect on rural household food consumption in some areas of the country, as discussed in more detail in Chapter 13.
- Financial liberalization measures, including reducing priority sector lending by banks, which effectively reduced the availability of rural credit, and thus made farm investment more expensive and more difficult, especially for smaller farmers.
- Liberalization and removal of restrictions on internal trade in agricultural commodities, across states within India.
- Liberalization of external trade, first through lifting restrictions on exports of agricultural goods, and then by shifting from quantitative restrictions to tariffs on imports of agricultural commodities. A range of primary imports were decanalized and thrown open to private agents. Import tariffs were very substantially lowered over the decade. Exports of important cultivated items, including wheat and rice, were freed from controls and subsequent measures were directed towards promoting the exports of raw and processed agricultural goods.

The proponents of such policies argued that they would necessarily lead to an acceleration of output growth in agriculture by increasing market-based incentives for agricultural investment and output. However, such an acceleration did not occur, as discussed in more detail in Chapters 5 and 6. In fact agricultural growth decelerated in the 1990s compared to the earlier decade, there have been declines in per capita foodgrain output and reduced rates of agricultural employment generation.

FINANCIAL LIBERALIZATION

Many would argue that financial sector reform and the associated dependence upon internationally mobile finance capital has been qualitatively the most significant aspect of the reforms. This is because such moves then make the other features of reform 'inevitable', in that no other measures would be seen as viable since they would be presumed to fail to retain 'investor confidence'.

Financial reform or liberalization is an omnibus concept that is not easily delimited. In India such liberalization touched on diverse aspects of the financial sector's functioning. In the banking sector, which dominates India's financial system, the reform involved three major sets of initiatives. The first set included those measures aimed at increasing the credit creating capacity of banks through reductions in the Statutory Liquidity and Cash Reserve Ratio, while offering them greater leeway in using the resulting liquidity by drastically pruning priority sector lending targets. This was combined with greater flexibility in determining the structure of interest rates on both deposits and loans.

The second was to increase competition through structural changes in the banking sector. While the existing nationalized banks, including the State Bank of India, were permitted to sell equity to the private sector, private investors were permitted to enter the banking area. Further, foreign banks were given greater access to the domestic market, both as subsidiaries and branches, subject to the maintenance of a minimum assigned capital and being subject to the same rule as domestic banks. Finally, a degree of 'broadbanding' of financial services was permitted, with development finance institutions being allowed to set up mutual funds and commercial banks, and banks themselves permitted to diversify their activity into a host of related areas.

Thirdly, banks were provided with greater freedom in determining their asset portfolios. They were permitted to cross the firewall that separated the banking sector from the stock market and invest in equities, provide advances against equity provided as collateral and offer guarantees to the broking community.

The reforms in the banking sector were accompanied by measures aimed at liberalizing financial markets. The process started with the repeal of the Capital Issues (Control) Act, 1947 and the abolition of the office of the Controller of Capital Issues. Companies could freely seek finance through the capital market, subject to the guidelines and regulations specified by the newly created Securities and Exchange Board of India (SEBI). Selected Indian companies were allowed to access international capital markets through Euro-equity shares. A range of non-bank financial companies, including private mutual funds were allowed to operate. Investment norms for NRIs were liberalized and Foreign Institutional Investors (FIIs) were allowed to register and invest in India's stock markets, subject to an overall ceiling (30 per cent) and a ceiling for each individual FII in a particular company's shareholding. The ceilings were then continuously relaxed. In addition, the government did away with the higher rate of capital gains taxation which applied on foreign and NRI investment that chose to invest in the stock market and leave in a short period of time.

In the initial post-reform period, official monetary policy was associated with a sharp rise in interest rates. This, of course, helped sustain inflows of foreign and non-resident capital in search of high returns, especially during the period of industrial boom driven by the pent-up demand for consumer goods. But it also eventually adversely affected private investment and subsequently aggravated the recession generated by the curtailment of government expenditure, once pent-up demand was satiated. Subsequently, even though the government brought down nominal interest rates, the recession still persisted. In addition, of course, the rise in interest rates substantially increased the interest burden of the government. The decision

to avoid cheaper borrowing directly from the RBI to finance the fiscal deficit meant that the government chose to resort to more expensive borrowing. This is an important reason why interest payments accounted for nearly one-third of total expenditure and half of revenue expenditure of the central government by the close of the decade.

EXCHANGE RATE POLICY

In terms of exchange rate determination, in a series of steps the government moved from an administered exchange rate to a situation by the end of the decade in which there was a unified, market-determined exchange rate of the rupee, which was fully convertible for current account transactions. Other financial liberalization measures had direct and indirect implications for exchange rate management by affecting the conditions for inflow and outflow of short-term capital into the country. The inflow of portfolio capital was permitted, through FIIs; as we have seen certain companies were allowed to raise capital abroad and external commercial borrowing was also allowed to selected companies.

Until the crisis in Southeast Asia in 1997–98, the government appeared keen on moving to full convertibility of the rupee. The official Tarapore Committee set up to draw up a road map for the process had recommended that the implementation be spread over 1997–98 to 1999–2000 and suggested preconditions to be met sequentially for this. Besides fiscal consolidation, a mandated inflation target and the restructuring of bank capital, the road map prescribed a stepwise process of financial liberalization. However, the East Asian crisis put plans for a rapid transition to capital account convertibility on hold for a time. Between 2001 and 2003, however, several restrictions on the capital account of the balance of payments were successively lifted or diluted, including regulations governing external borrowing and investment abroad by Indian firms, rules regarding the use of foreign venture capital, and even the rules regarding the possibility of dollar accounts held by domestic residents. However, even in late 2003, the capital account was still not fully convertible. Rules for investment abroad by Indian firms were also liberalized.

Overall, one of the consequences of financial sector reform was India's growing dependence on volatile short-term flows of capital in the form of FII and NRI investments and NRI deposits. Combined with the decision to allow the value of the rupee to be determined by market forces, which made central bank purchases and sales of foreign exchange the only means by which the government could influence the value of the rupee, this resulted in uncertainty regarding the value of the rupee. Further, domestic policies with regard to expenditure, interest rates and exchange rates were increasingly influenced by perceptions of how it would affect whimsical foreign investor sentiment. This substantially reduced the maneuverability of the government, and made it difficult for it to change policy track, even if it chose, in order to deal with the problems that emerged during the period of reform.

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The Political Economy of Reform

Advocates of reform argue that in the wake of the balance of payments crisis of 1990–91, India had no option but turn to the multilateral institutions for support and adopt an IMF-style adjustment strategy. In fact, however, the option of a loan under the Structural Adjustment Facility was not the only one available to the government in 1991. India could have combined a smaller volume of non-conditional borrowing from the IMF with some import controls to tide over the problem created by falling reserves and retained for itself the right to fashion an appropriate response to its growing balance of payments difficulties. And some economists had argued at that time that India lost an opportunity to build its reserves because of the reticence of the banking system to accept transfers of deposits denominated in West Asian currencies held by Indians returning from the Gulf in the wake of the war, because of the uncertainties created by the war.

That of course leaves unanswered the question as to why Indian capital, which was obviously a beneficiary of the protection offered under the earlier regime of intervention, went along with and in fact celebrated liberalization of the kind introduced in the 1980s and 1990s. The exceptions to this, in the form of the protests by the so-called 'Bombay Club', complaints of the non-cooperative character of foreign investors by the Confederation of Indian Industry, and periodic demands for higher state expenditure to counter recessionary tendencies, were few and far between.

There were two aspects to this changed attitude of Indian capital. To start with, given the sluggish growth of the home market in the 15 years starting in the mid-1960s, one possible alternative option to major structural reforms would have been to make an effort to break into export markets, which could have provided a new stimulus to industrial expansion and a new basis for capital accumulation. But export markets were dominated by metropolitan capital. To permit Indian capital a share of this export market as a junior partner, metropolitan capital demanded a price, namely, a share of the Indian market. On the other hand, breaking into export markets on its own required, besides the backing of the Indian state, a massive effort on the part of Indian capital, which it proved incapable of making. This was at least partly due to its unwillingness to accept a certain minimum 'discipline'. The export prospects of Indian capital operating on its own consequently remained bleak. Collaboration with metropolitan capital was the soft option.

Secondly, at this time a schism developed within the ranks of Indian capital, as a result of the proliferation of the Indian capitalist class that took place during the years of import-substituting growth and later. There were three factors that led to such proliferation. The first is related to the process of introduction of new products.

In any growing economy there is not simply an expansion in the level of demand for a given set of pre-existing products, but a change in demand in favour of products which are new. In principle, the new products could be produced by already established capitalists, and often are; but there are a number factors that militate against this and favour proliferation: first, the technology for these products is in most cases controlled by a small number of multinational corporations, which are at the leading edge of technological change worldwide. For those MNCs, the control over technology is the most potent mechanism for the appropriation of profits. Such firms often prefer to link up with capitalists who are a rung below the established top stratum. Capitalists in this rung are sufficiently large to have the 'connections' and be able to mobilize the necessary resources to set up plants of a minimum size where economies of scale are important; and yet they are not so large that the MNCs would find it difficult to exercise leverage *vis-à-vis* them. It

was for this reason that even at a relatively early stage of Indian industrialization, some small business groups like the Kirloskars, for example, could grow rapidly by securing collaboration agreements transferring technology and new products to the domestic economy. Secondly, in the case of products where economies of scale are not that important (above a certain modest limit) and where technology can be copied and assimilated easily, established big business houses, preferring a low risk strategy (or exhibiting what Josef Steindl [1964] had called 'safety preference'), are less ready to enter than small producers. Thirdly, to the extent that new products are often improved versions of old products, e.g. automobiles, established producers would naturally be reluctant to move to new products which would affect their markets for old products, unless compelled to do so by the entry of altogether new firms undertaking the production of new products and outcompeting them. Finally, given the segmented nature of markets for manufactures in an economy with low but unequally distributed average incomes, the rate of return on investment varies substantially across products. Established business groups, which straddle a number of activities and have the economic wherewithal to diversify into new areas that are relatively more profitable, are reluctant to either expand in existing or enter new areas where the rate of return may be positive and significant, but is 'inadequate' relative to areas offering a range of 'maximal' returns on investment.

It should be clear that we do not imply that the introduction of new products is *exclusively* associated with the entry of new entrepreneurs into the ranks of capitalists, but simply that it is one of the processes favouring proliferation, i.e., a shift in the relative balance away from established big capitalists in favour of smaller but sizeable capitalist groups, or even in favour of altogether new entrants into business. But proliferation occurs even without the introduction of altogether new products, and this in practice is proliferation of much the more pervasive kind. For a variety of reasons, different capitalists groups occupy different spaces, not all spaces at any given time being accessible to all. In the event, in India over time there were a number of areas outside the traditional bases of existing monopolistic groups, such as trade, services of various kinds and operations abroad by NRI groups, which served as sites for primary accumulation of capital. A typical example is trade, which saw the growth and proliferation of relatively independent capitalist groups, some of which on occasion (exemplified by the Ambanis who were initially in the synthetic fibre trade) made relatively successful forays into industrial production. This has been particularly true of groups operating in areas (like steel, tyres, and cement), which for one reason or another have been through periods of shortage, a burgeoning black market and extremely high margins from trade. Another example was finance. With the nationalization of the major banks in 1969, the ability of domestic capital to use the financial sector as a site for accumulation was undermined. However, matters changed substantially in the late 1970s, when starting with the process of dilution of equity by FERA companies, the stock market came into its own. The subsequent periods of speculative boom in the stock market allowed some insiders within the erstwhile financial community to accumulate substantial sums of capital, most often at the expense of the small middle class investor. Nothing reflected this possibility more than the stock market scandal of 1992, involving sums estimated up to Rs.9,000 crore, manipulated by a few operators from within the financial community.

The emergence of new groups which accumulated capital outside the traditional routes is illustrated by the growth of some regional capitalist groups, especially in certain area of southern and western India. For example, the evidence suggests that a number of the new business groups in a state like Andhra Pradesh accumulated the seed capital necessary for investment in industry in the agriculturally successful districts of coastal Andhra. Such groups were interested in the abolition of state regulations which offered protection to traditional oligopoly and wanted to use foreign collaboration as a means of entry into the industrial sector. Such groups therefore became vocal supporters of policies towards liberalization and globaliztion.

Overtime, groups which accumulated capital in this fashion sought to diversify into manufacturing, not only by entering new niche markets, but also by investing in large capacities in industries characterized by economies of scale (like synthetics and petrochemicals in the case of the Ambanis). Traditional business groups, protected in the past by the barrier to entry created by the government's licensing mechanism, had hedged against risk by investing small sums embodied in uneconomic plants in each individual industry. They were thus unable to compete successfully with the new entrants, who in turn could face up to international competition and were less averse to import competition.

Finally, a high degree of product concentration in many areas did not preclude a process of proliferation of the capitalist class. One mechanism for such proliferation was the rapid growth of the small scale sector, which occurred for a number of reasons. To start with, the government reserved some 870 products for the small scale sector. Although many of these were areas where in any case the small sector had an inherent advantage, such reservation meant that large firms buying components and intermediates from the small sector could not threaten competition based on backward integration.[1] Further, to the extent that price control in areas like steel and cement discouraged entry by large business groups, which could diversify into areas offering maximal returns, it left open some of these areas to medium and small capitalists. Needless to say, the extent to which these niches emerged and permitted expansion of small and medium capital depended on the rate of growth of the economy itself. Proliferation was most likely in periods of boom.

All this goes to show that we can legitimately look upon the economy as an agglomeration of different spaces with the occupants of one space being confronted with a degree of inaccessibility as far as the other spaces are concerned. The proliferation of the capitalist class is predicated on such segmentation. This proliferation however has very important implications. Established big capital, insofar as it cannot enter into certain spaces and insofar as it is not able to take full advantage of the entry of new products, finds its relative position in the economy worsening over time. The proliferation of the capitalist class in other words, while it does contribute to a broadening of the base upon which the entire capitalist order rests, also results in a relative decline of the weight of established big business. To reverse this decline, the latter looks for new avenues. One obvious choice is expansion abroad. One should distinguish here between two different types of expansion abroad: one is simply expanding activities abroad which requires little export of capital from the domestic economy since it is largely locally financed; the other involves the export of capital through the non-repatriation of exchange earnings which, at the very least, involves the acquisition of rentier status, but may help the expansion of activities as well. The non-repatriation of exchange earnings, for a given level of domestic activity being maintained, has to be financed for the economy as a whole through larger international borrowing.

[1] 'Backward integration' means supply linkages with other economic activities.

The second avenue open to established big business is to move into the space occupied by the public sector or smaller capitalists; and hence they demand an opening up of space. This can be achieved by the elimination of anti-monopoly legislation, the removal of licensing requirements, the removal of legislation 'reserving' certain sectors for small capitalists, a regime of high interest rates that squeezes small capitalists, the privatization of profitable public sector units, and the delinking of the public sector from budgetary support of any kind. In short, big business which, to start with, is the beneficiary of state controls of various kinds, begins to chaff against these controls when proliferation reaches a certain stage and it feels confined for space. Its demands for greater space form a component of the package of demands made by multilateral institutions like the IMF and the World Bank; hence it extends at least a qualified support to the neoliberal 'liberalization' programme, no matter how uneasy it feels about some other aspects of such programmes. And even this unease about other aspects, such as flexible exchange rates, convertible currency, import liberalisation, etc. would not be as acute as one might imagine if big business has itself meanwhile expanded its activities abroad to a considerable extent. Among certain other sections such as the agricultural capitalists the regime change meets with qualified approval, though parts of it are objected to. Agricultural capitalists, while being hostile to the withdrawal of subsidised inputs and subsidised credit, look with favour upon the possibility of exporting at favourable prices in the international market.

In the event, a substantial section of domestic capital was willing to make compromises with metropolitan capital on the terms that the latter demanded: it was all for allowing metropolitan capital to capture a share of the Indian market even at the expense of the entrenched capitalists, not to mention the public sector, in the hope of being able to better its own prospects as a junior partner, both in the domestic as well as in the international market. It was thus in favour of import liberalization, a full retreat from Nehruvian interventionism, and accepting the kind of regime that metropolitan capital generally, and the World Bank and the International Monetary Fund as its chief spokesmen, had been demanding. The more powerful and the more entrenched monopoly houses however were more circumspect. They would not have minded import liberalization in areas other than their own, including in areas dominated by the public sector; they would not mind collaborating with foreign capital to add to their empires and hence a degree of relaxation of controls to further facilitate such collaboration; but they would not like encroachments by metropolitan capital upon their own empires. Their attitude towards neoliberal economic liberalization therefore was more ambiguous.

Support for liberalization was growing not just among a section of industrial and agricultural capital. A whole new category of an altogether different kind of businessman was coming up, containing those who were more in the nature of upstarts, international racketeers, fixers, middlemen, often of NRI origin or having NRI links, often linked to smuggling and the arms trade. Such private agents in any case did not have much of a production base, and their parasitic intermediary status as well as the international value of their operations naturally inclined them towards an 'open economy'. And finally, one should not exclude a section of the top bureaucracy itself, which had close links with the IMF and the World Bank, either as ex-employees who might return any time to Washington D.C., or through being engaged in dollar projects of various kinds, or as hopeful aspirants for a lucrative berth in Washington D.C.; the weight of this section in the top bureaucracy had been growing rapidly, and its inclination naturally was in the direction of the Fund–Bank policy regime (Kurien 1994). Thus, quite apart from the growing leverage exercised by the international agencies in their capacity as 'donors', the internal contradictions of the Nehruvian '*dirigiste*' policy regime generated increasing support within the powerful and affluent sections of society for changing this regime in the manner desired by these agencies.

MIDDLE CLASS SUPPORT

Besides this support from large corporate capital, the large and politically powerful urban middle classes, along with more prosperous rural farming groups, whose real incomes increased in the consumption-led boom of the 1980s, actively began to desire access to international goods and gave potency to the demands for trade liberalization. And of course the technological and media revolutions, especially the growing importance of satellite television, imparted a significant impetus to the international demonstration effect, which further fuelled liberalizing and consumerist demands.

One important social change which was arguably influential in creating pressures for the shift in macroeconomic strategy was the accelerated globalization of a section of Indian society. Apart from the media, one major instrument of this was the postwar Indian diaspora. The 'NRI phenomenon', by means of which a qualitatively significant number of people from the Indian elites and middle classes actually became resident abroad, contributed in no small measure to consumerist demands for opening up the economy. The importance of NRIs was not only because they were viewed as potentially important sources of capital inflow, but also because of their close links with (which in many cases made them almost indistinguishable from) dominant groups within the domestically resident society. It should be remembered that while the reforms failed in the aggregative sense and also in terms of delivering better conditions for most of the Indian population, there was anticipated and achieved a definite improvement in material conditions for a substantial section of the upper and middle classes. Since these groups had a political voice that was far greater than their share of population, they were able to influence economic strategy to their own material advantage.

While the neoliberal economic reform programme entailed a changed relationship of government interaction with economy and polity, it was not a 'withdrawal of the state' so much as a change in the character of the association. Thus, while the state effectively reneged on many of its basic obligations in terms of providing its citizens access to minimum food, housing, health, and education, state actions remained crucial to the way in which markets functioned and the ability of capital to pursue its different goals. Government and bureaucracy remained crucial to economic functioning at the end of more than a decade of reforms; in fact the overall context was one of greater centralization of economic and financial power. Many had believed that a 'retreat of the state' and the exposure of the economy to the discipline of the market would cut out arbitrariness of decision-making and the corruption that is inevitably associated with it. It would streamline the functioning of the economy by making it a 'rule-governed system', though admittedly the rules of the market. What happened instead in the Indian economy during this period of structural adjustment was an increase in the level of corruption, cronyism, and arbitrariness to unprecedented levels. As we have seen, the privatization exercise was an utter scandal. Precious natural resources, hitherto kept inside the public sector, were handed over for a pittance (and alleged 'kickbacks') to private firms with dubious objectives. The case of the Enron deal where massive contracts were signed without an open tender and at inflated capital costs, with guaranteed rates of return, was just one example of the wider corruption that increasingly pervaded the system. In short, the 'discipline of the market' proved to be a chimera.

It could be argued that the centralized, centralizing, and increasingly authoritarian state is in fact a necessary requirement for this type of liberalization which is based more on external legitimisation (from foreign financiers and the perceived discipline of international markets) rather than on internal legitimacy derived from the support of the majority of its citizens. Such a change in the nature of the state may become a fallout of the substantially increased income inequalities associated with liberalization and the social and political processes that they unleash. These inequalities have accentuated certain longer-term structural features of Indian society, whereby more privileged groups have sought to perpetuate and increase their control over limited resources and channels of income generation in the economy. This in turn has involved the effective economic disenfranchisement of large numbers of people, who may occupy whole physical spaces in rural areas, or may be urban slum dwellers who constitute both the reserve army of labour for industrialization and the most fertile source of labour supply for extra-legal activities. The basic disregard for 'rule of law' which has characterized Indian economic functioning over several decades, became even more pronounced in this period, with both economic and other lawlessness becoming accepted features pervading all aspect of civil society, and have allowed everything – even the rights of citizens – to become marketable and negotiable. Meanwhile ordinary citizens tended to experience reduced civil liberties and security along with worsening socio-economic rights, which may even have been necessary to allow the more centralized state to direct particular forms of lawlessness to the benefit of powerful agents and groups.

These concomitant trends of greater economic and financial centralization and increased income inequality in turn operated to aggravate the various regional, fissiparous, and community-based tensions that have become such a defining feature of Indian society and polity. Obviously, we are not suggesting that all such tension had a direct material underpinning.

Nevertheless, it is true that the combination of greater material insecurity in terms of both lower real incomes and more precarious employment opportunities for a very large section of the population, with the explosion of conspicuous consumption on the part of a relatively small but highly visible minority, could have very adverse social and political consequences. The frustration that may arise because of the gap between aspiration and reality for growing numbers of people in the system can be only too easily directed towards any apparent or potential competitor in such a system, or even to those who are not in competition but simply represent a group that can be attacked with relative ease. The streak of venom that was periodically directed towards various minority groups can be seen as one expression of this trend. The inability to confront those who are actually benefiting from the system, or even the lack of desire to do so given that they still have the power to distribute some amount of material largesse, meant that they cannot be the objects of any aggressive vent for frustration. Rather, the outlet was increasingly found in terms of growing antagonism, increasingly finding violent expression, towards other categories of people who are nearer home, closer in terms of lifestyle and more susceptible to such attack. It is worth noting that often these groups were already the most disadvantaged and materially weak sections of society.

There is a broader international context to this. Across the world, in both developed and developing countries, there is a greater tendency on the part of the rulers, and those who are privileged in society, to ignore the interests of the majority and to blatantly push for those policies that will only benefit a small minority. The rise of finance capital and the hugely powerful role played by speculative capital in determining the fortunes of even large industrial countries has made this even sharper. Increasingly, governments point to the threat of capital flight as the reason why they cannot undertake basic measures for the welfare of most of the citizens, since anything that involves more expenditure for the people is inherently viewed with disfavour by international capital.

Of course, this international tendency then has its counterpart in each national economy, as particular groups that actually benefit from the process seek to establish that 'there is no alternative'. And so we have the spectacle of local elites and governments desperately advocating and pushing through policies that are likely to be to the detriment of the majority of the people. In many developing countries this process has become so extreme that not only present incomes but even future prospects and the natural resource wealth of the country have been squandered or handed over to multinational interests.

While this may be a depressing description, it is also the case that there are definite possibilities for changing this scenario towards more positive social outcomes, especially at a time when global capitalism also appears to be in the throes of recession. Of course the degree to which such change occurs will depend upon the extent of social and political pressure that can be brought to bear upon the state to change course in terms of economic strategy. This requires not only that the current dissatisfaction with neoliberal economic strategy, which is widespread but dispersed, be brought together to form more effective resistance and active pressure for change. It also requires that the basic contours of an alternative strategy need to be more widely disseminated.

We outline such an alternative in schematic form in the final chapter of this book. For the moment, we look at the growth performance of the Indian economy in the decade of reforms.

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Redefining Reform

We have tried to argue in this book that the experience of neoliberal economic reforms in India since the early 1990s belied the expectations of its proponents. In a nutshell, the market failed. It failed in the aggregate to deliver the promised growth and 'efficiency' which would have justified the greater external vulnerability that the strategy necessarily entailed. And it failed very dramatically in specific areas, such as in infrastructure provision, employment generation, and the food system. The question that arises, then, is whether a viable alternative exists, and if it does, what its contours can be.

THE ALTERNATIVE STRATEGY

One point that must be borne in mind is that since economic policy does not occur in a vacuum, the effects of the neoliberal strategy cannot be wished away in terms of the greater degree of integration with world markets and external vulnerability that are now characteristic of the Indian economy. This does not mean that there is no option but to succumb to this heightened vulnerability and hope for the best. Rather, it is necessary to work out a national economic policy that takes this vulnerability into account. Reduced manoeuvrability by no means implies no manoeuvrability at all.

In an immediate sense such manoeuvrability is required to exploit the currently available opportunity to spur growth and redistribute its benefits, offered by the combination of large foodgrain stocks, considerable unutilized capacity in industry, and comfortable foreign exchange reserves. The obvious response to this combination of circumstances, which would also help to decrease unemployment and alleviate poverty, is to launch a massive food-for-work programme geared to building rural and urban infrastructure. And these very circumstances would ensure that such an effort, which would require increased financial outlays by the government, would result in output and employment increases rather than in inflation.

Advocates of reform argue that this option is infeasible since it would result in an increase in the fiscal deficit and contribute to the already unsustainable level of public debt. There are three reasons why that argument is fallacious. First, insofar as food stocks carried by the government, which add to its expenditure, would constitute a significant chunk of the 'expenditure' incurred on a food-for-work programme, it would make no difference to the fiscal and debt situation. Second, even to the extent that such a programme involves a non-food financial component, that additional expenditure would in large part be financed by the increases in tax and non-tax revenues of the government that an increase in output and demand would entail. And, finally, given the already low levels of the tax-GDP ratio in India, the government is definitely in a position to increase tax rates and widen the tax base to raise the tax-GDP ratio. This would go a long way in financing the expenditures that would be incurred.

The last of these reasons points to a second area in which initiatives are required to halt and reverse trends associated with the neoliberal reform process, namely, the long-term decline in the tax-GDP ratio. It is no doubt true that intensifying the tax effort and allowing, if necessary, the deficit on the government's budget to rise, while making economic sense in the current context, would be received with alarm by foreign capital, in particular foreign financial capital. This has provided advocates of reform with the argument that such moves, when not favoured by international finance, can lead to a decline in capital flows and even capital flight that would precipitate a financial crisis.

This, however, does not mean that the effort at adopting appropriate economic policies aimed at restoring domestic economic balance should be abandoned, but rather that the terms on which foreign financial capital flows into and operates in the country need to be regulated. Policies such as minimum lock-in periods, differential rates of capital gains taxation for gains registered through short and medium-to-long-term investments, and even a transactions tax of the Tobin-tax[1] kind need to be imposed, to reduce the volatility of and the country's dependence on cross-border financial flows. These are policies that even countries like Chile, long-favoured by the Bretton Woods institutions, have followed. They can, therefore, quite legitimately, be adopted by a government pursuing an alternative programme, which finds that reducing external vulnerability is a prerequisite to fulfil reasonable national economic goals.

However, reduced vulnerability does imply that the kind of developmental agenda that was worked out in the immediate postwar years is no longer adequate. While the effort to make optimum use of 'available' foreign exchange earnings implicit in strategies of the Feldman-Mahalanobis kind is warranted, in practice the strategy paid little attention to expanding the pool of foreign exchange.

This brings us to the next aspect of the alternative strategy incorporating intervention, which consists of policies to be pursued with long-run goals in mind. To start with, such an alternative must transcend the dichotomy between production for the domestic market and production for export. In its archetypal form that dichotomy is reflected in arguments that make a case for industrialization based on the home market because international inequality provides grounds for 'export pessimism'. In the debate on the transition to capitalism that led up to the industrial revolution, one issue of contention related to the relative roles of purely 'internal' factors in the form of structural change, as opposed to 'external' factors like the effects of commercialisation and the growth of markets in determining that transition. Whatever the merits of those contending arguments with regard to the principal determinant, one thing appears clear with hindsight. Successful capitalist industrialization cannot occur in a context insulated from world markets, but requires consciously engaging those markets as part of the strategy of growth.

We use the term 'engaging' advisedly. World markets are not benign,

[1] The US economist James Tobin had recommended the imposition of a very small tax on all foreign currency transactions. They would be too small to affect the profitability of most real sector transactions, but coul act as a deterrent on short-run speculative capital flows.

autonomous forces that spur efficient third world industrialization. On the contrary, they embody all the inequalities characteristic of the world system. Engaging those markets involves therefore using all the weaponry in the hands of a developing country, including the power of its state, the foundation that its home market provides, the ability of its scientific and technical personnel to override the domination implied in the control of technology by a few transnational firms, and the advantages of the late entrant (varying from low wages to a less codified legal framework), to prise open those markets that inequality suggests are hermetically sealed for them.

It also implies that, especially for countries with a potentially large domestic market, domestic capital must be provided with both time and space to achieve the level of competitiveness that is required to face up to international competition. This suggests a strategy of selective and temporally phased import controls, which while allowing access to crucial capital goods, raw materials, and intermediates, provides a degree of space for domestic production of a range of final goods. There are two obvious corollaries of this. First, India should maximize the extent to which it can still protect domestic production with tariffs, anti-dumping duties, and state procurement. Secondly, it must abjure any effort to reduce and rationalize import tariffs across-the-board to bring them down to extremely low levels. Differential tariffs that minimize the liberalization of imports of consumer goods and an import tariff structure that does not subject capital goods producers to negative protection must be put in place.

This brings us to our next point. A successful growth strategy has to be based on an activist state. There is no relationship between the existence of an activist state and autarky or, for that matter, insularity. One valid criticism of the import substitution years in countries like India is that it neglected exports. While exports cannot constitute a basis for growth in a large developing country, in an interdependent world one cannot finance the imports that accompany the process of growth without an export thrust. It is for this reason that all successful late industrializers, including the so-called Newly Industrializing Economies (NIEs), had pursued a 'mercantilist' export policy which emphasizes pushing out exports at whatever cost. Such a policy involves a continuous restructuring of the production base of the system in both quantitative and qualitative terms, which requires both technology and investment. Investment matters for two reasons: first, the larger the size of investment the larger the share that can be devoted to

modernization as opposed to 'expansion'; second, since for any incremental capital output ratio, higher investment implies higher growth, capacity expansion proceeds at a pace that allows the incorporation of new technology at the margin. For these and other reasons, the rate of growth of manufacturing exports of an economy is dependent on the investment ratio.

Development economics in the early years singled out investment as the key to growth. In fact the group of highly distinguished development economists headed by Arthur Lewis who authored the well-known *Measures* document of the United Nations (1951) made raising the investment ratio the cornerstone of its recommendations for development in the underdeveloped countries. The emphasis shifted only with the neoclassical critique of the late sixties.[2] It was the *efficiency of resource use*, as emphasized by neoclassical writers, which gradually came to occupy centre-stage; what mattered, according to this perception, is the *economic regime* within which development took place, whether or not this *regime* was conducive to the achievement of efficiency of resource use. What a regime conducive to such efficiency on the neoclassical argument would do to the investment ratio was never discussed, a reflection essentially of a shift of attention from the macro to the micro issues underlying the development process (and of course to a 'marketist' stance in this micro discussion). In short, the investment ratio dropped out of the picture as a significant phenomenon to concentrate attention upon.

However, while economic analysis may have ignored the link between investment rates and growth, economic reality persisted in stressing it. This is evident from cross-country correlations of investment ratios, output growth rates and export growth rates. An analysis based on twenty years (1968–88) data for 25 developing countries (Patnaik and Chandrasekhar 1996) showed a close correlation between output growth and the investment rate (or the ratio of investment to income). Similarly there was an extremely close relationship between output growth and export growth. If it is investment which drives output growth then the high correlation between output growth and export growth must make itself visible in terms of a high correlation between investment ratio and export growth, which it does.

There are good theoretical reasons why a high investment ratio *ceteris*

[2] The neo-classical critique was elaborated among other places in Little, Scitovsky and Scott (1970).

paribus should give rise to a strong export growth performance. International trade in the different commodities grows, over any period, at different rates. Given these growth rates in world trade, the rate at which a particular underdeveloped country's exports grow would depend to a very significant extent upon its production structure and the rate at which this structure is changing. In particular since the underdeveloped countries are, by and large, saddled with production structures specializing in commodities with relatively stagnant world trade, success on the export front depends crucially upon the ability to transform the production structure rapidly in the direction of commodities where world trade grows faster. And the rapidity of this transformation is linked to the investment ratio: the higher the investment ratio, the faster the transformation of the production structure and hence the greater the ability to participate in the faster-growing end of the world trade, i.e. the greater the rate of export growth.

An activist state is needed not merely to raise investment rates, but to coordinate the export thrust. The evidence from East Asia suggests that such coordination was crucial, because a mercantilist industrial policy rather than market determined comparative advantage was crucial in establishing a foothold in international markets. There is enough evidence that countries like Japan, South Korea and Taiwan pursued strategic and anticipatory industrial policies (although of slightly different types) as a run up to their competitive success, and that the late-1990s crisis was linked to their decision to dismantle that industrial policy framework. Hence, even when a high investment rate is realized through the agency of private entrepreneurs, the government needs to ensure that an adequate share of such investment is allocated to sectors selectively chosen as thrust areas for exports and embodied in technologies and plant scales that enhance international competitiveness. During the import substitution years when the thrust of policy was to build a domestic industrial base using the economic space provided by a protected market, state policy was largely directed at regulating the adverse consequences – in the form of concentration, monopolistic pricing, uneconomic scales and a skewed production pattern – of inadequate competition or rivalry. But that intervention has now to take on a new form, with the emphasis on matching microeconomic investment decision-making with a coordinated or 'planned' export thrust.

An important instrument in realizing the objectives of this new form of

intervention is monetary policy. The evidence seems to suggest that interest rate differentials are a useful instrument for realizing an export thrust of the kind described above. This automatically suggests that financial liberalization of a kind that does not permit such differentials, and weak banking systems in which such policies can be misused, need to be reformed, with the imposition of capital adequacy norms and transparent procedures.

Activism of this kind has as its corollary two features. First, an activist state should be in a position to discipline its industrial class (Wade 1990, Amsden 1989). Second, activism requires the mobilisation of adequate resources by the state to sustain that strategy (Singh 1995). The need to discipline the industrial class arises because, even while departing from the detailed physical controls characteristic of the import substitution years, the strategy being elaborated here requires a substantial degree of strategic targeting and coordination by the state. Through incentives, on the one hand, and measures to enforce compliance, on the other, the government must be in a position to influence investment decision-making at a microeconomic level. Based on the segment of the world market that is being targeted, the coordinating agency should be able to influence the choice of product, technology, scale of production, and price.

Needless to say, imposing such discipline requires the backing of other sections of society, which defines the third prong of an alternative strategy. Social support for a strong state (and one which is accountable and responsive to public need) is most often won in a situation where land reforms have dismantled structures that provide the base for a collusive elite. The vital necessity of land reforms is underscored by the fact that even the successful East Asian capitalist economies owe their success inter alia to the postwar land reforms that they had.

But land reforms are needed not merely as an instrument of mobilizing political support. A thrust towards land redistribution and greater social expenditures in the rural areas which are best undertaken under the aegis of directly elected decentralized governing bodies (e.g. the panchayats in India), is essential also for widening the home market immediately, ensuring a rapid increase in agricultural output (as has happened in West Bengal, for example), and increasing the potential for direct and indirect employment generation. To that end land reforms would have to be accompanied by investments in the agricultural sector – in irrigation and water management and other kinds of rural infrastructure – that permit an acceleration of industrial growth. Typically such institutional changes are also associated with increasing employment, so that the overall employment generation in the economy increases as a result, especially relative to an alternative trajectory. This would not only broaden the base of development but also create decision making structures through devolution that are crucial for generating the strength and the accountability needed to make the state capable of functioning as a disciplining force.

Globalization is fundamentally a centralizing tendency, drawing disparate economies and sectors into the vortex of a world controlled by a few decision makers. It also replicates this centralization in economies which it integrates into the world system, creating strong domestic interests that support the case for an open economy and a marketist strategy. The suggestion that the nation state is no more a meaningful category comes from those who find in an 'integrationist' strategy greater economic benefit than from any strategy of reserving domestic space for domestic interests, so that some forces that advocated protection and state intervention in the 1950s, now support a liberal economic regime. The problem, however, that is such a regime marginalizes the disadvantaged, who constitute a majority in most developing countries – a majority which, because of centralization, cannot make the case that the attenuation of the nation state challenges their already meagre standards of living. This however offers an opportunity to forces seeking an alternative to blind marketism. They constitute the social base which can legitimise the effort to reckon with the adverse consequences of globalization. This implies that political and economic decision-making needs to be decentralized so that segments who believe that there must be an alternative to unbridled marketism can find a voice.[3] It also means that any alternative strategy must immediately address their basic needs so as to consolidate their support for that alternative.

Thus an alternative growth strategy does involve economic 'reforms', though not of the neoliberal marketist variety. The objective of the reforms must be to widen the home market, to provide the broadest possible basis for development through appropriate structural change. But broadening of the market without a stimulus for its expansion can be counterproductive. And a state faced with macroeconomic disequilibria is hardly in a position to provide that stimulus. This implies that macroeconomic disequilibrium, reflected in high revenue deficits, has to be corrected through direct taxation and a reduction in inessential expenditure. Through greater discipline in tax-enforcement, changes in tax laws, removing certain kinds of exemptions, and an adjustment of rates for top income brackets, the revenue from income taxation should increase.

[3] This is now recognized particularly by political parties of the Left. See Isaac (2000) for an account of the Kerala experiment with democratic decentralization involving devolution of a part of plan resources to elected bodies at the local level.

With greater resort to direct taxation, the tendency towards garnering revenue from indirect taxes and administered price hikes would have been reversed, which itself would be an anti-inflationary measure. Even so, it is necessary in addition to protect the poor from the effects of such inflation as would occur. And this is best done through an extension of the public distribution system, both geographically into the rural areas as well as in terms of its commodity coverage.

The other component of macroeconomic disequilibrium which plagues developing countries like India, namely the deficit on the current account of the balance of payments, is dealt with more directly in the strategy being proposed. The growth of income and exports here are not made dependent on the pursuit of an open economic regime, but are a fallout of the activism of the state. This implies that the combination of selective but stringent import controls and an export thrust itself provides the basis for a correction of balance of payments disequilibria. Further, growth in a broad-based development strategy is not dependent on access to international finance, but uses the foothold offered in part by the home market. This implies that even the direct link between growth and vulnerability, or dependence on 'hot money' flows is snapped, achieving the principal objective of the alternative traverse.

An important feature of this package is that its focus on the expansion of the domestic market implies emphasizing employment generation and the provision of adequate and sustainable livelihoods to the population. It should be noted that production for the mass market for manufactures tends to involve goods which have a higher labour intensity of production than the production of luxury goods. All these issues are especially important not only because of the obvious welfare and equity implications, but because, in the absence of such development, the political and social tensions unleashed by the inequalizing effects of globalization are likely to become very difficult to contain.[4]

A package of policies of this kind would not merely help accelerate growth with some attention to equity, but would break the nexus between even a minimal rate of growth and an acceleration of dependence on foreign finance. Any access to finance would essentially serve to raise the rate of growth beyond that critical minimum, which is not subject to the uncertainties that the external vulnerability stemming from dependence on international capital generates. It is thus that the 'opportunity' offered by the rise to dominance of finance capital can be used by a developing country to engage international markets. That is the virtuous circle that commends itself in the new environment is one in which an effort by an activist state to engage international markets for goods and services provides it with the foundations needed to engage international capital markets and use them as one more weapon to further prise open unequal international markets. There are two prerequisites for such a state. It should be willing to launch an alternative strategy that permits a degree of autonomy from the agenda imposed by international finance. And it should be able to undertake the progressive structural reforms which would be necessary to create the social base and sanction for such an effort. India awaits the emergence of such a state.

[4] This point is now recognized even by mainstream political economists such as Dani Rodrik (1999) who have pointed out that a general political movement against globalization may be the result of not taking into account more seriously the social consequences of globalization.